UNITED STATED BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
Honorable Howard R. Tallman

In re:	)	
	)	
TABERNASH MEADOWS, LLC, a Colorado limited liability company, EIN: 84-1482685,	)	**Case No. 03-24392 SBB**
	)	**Chapter 11**
	)	
Debtor.	)	
	)	
	)	
LAKESIDE AT POLE CREEK, LLC, and LAKESIDE AT POLE CREEK TOWNHOMES, HOA, LLC,	)	
	)	
Plaintiffs,	)	
	)	
v.	)	**Adversary No. 03-1899 HRT**
	)	
TABERNASH MEADOWS LLC; TABERNASH WATER & SANITATION DISTRICT; PEAK NATIONAL BANK; ELAM CONSTRUCTION; and BOARD OF COUNTY COMMISSIONERS FOR GRAND COUNTY,	)	
	)	
Defendants.	)	

ORDER GRANTING PERMANENT INJUNCTION

THIS MATTER comes before the Court on the Motion and Brief for Permanent Injunction filed August 5, 2004, by Plaintiffs Lakeside at Pole Creek, LLC and Lakeside at Pole Creek Townhomes, HOA, LLC [collectively "Plaintiffs" or "Lakeside"]. The Motion seeks to prevent the Defendant Debtor, Tabernash Meadows LLC [the "Debtor" or "Tabernash"], from calling an Irrevocable Standby Letter of Credit dated August 7, 2000, [the "LOC"] in the amount of $250,000.00 as provided for in that certain Real Estate Purchase and Sale Agreement dated March 30, 2000, [the "Agreement"] between Tabernash, as Seller, and Lakeside, as Purchaser. The Stipulation of Facts submitted by the parties demonstrates that the relationship between these parties, in and out of the Debtor's Chapter 11 case and this Adversary Proceeding, has been a long and tortured one. The Court has considered the parties' Stipulation of Facts, the testimony, the exhibits and arguments presented at hearing and their written trial briefs, and is ready to rule.

The Court makes this ruling as its findings and conclusions under FED. R. BANKR. P. 7052 and is the Court's final judgment.

FACTS

The Court adopts the parties' Stipulation of Facts. But, to briefly summarize the facts, the Debtor and its managing principal, Robert Yaklich, sought to develop raw land in Grand County. The original plan was to construct roads, build water and sewer facilities and furnish other utilities to allow such development to occur through the sale of platted, subdivision lots. Tabernash Water & Sanitation District [the "District"] was a special district created to accomplish the infrastructure development. Lakeside entered into the Agreement to purchase 28 lots from the Debtor and build 56 duplex dwelling units on approximately 8.45 acres, comprising a replat of Lot MF-1 of the Pole Creek Valley Subdivision as Lakeside at Pole Creek Townhomes, Lots 1A-28B. Under the Agreement, the LOC was to be held until the sale of the last (8) units and applied at a rate of $30,000 per lot, or be paid to the Debtor as liquidated damages for Lakeside's failure to purchase the lots.

For a variety of reasons, the Debtor was not successful in completing its development plans, and filed a Chapter 11 case. Eventually, the District obtained relief from stay on April 14, 2004, to complete its foreclosure on the Debtor's real property. When this occurred, Lakeside had not purchased all of the lots provided for in the Agreement. The Debtor now seeks to demand payment under the LOC by Lakeside's bank, Citiwide Bank of Aurora, Colorado [the "Bank"] for Lakeside's failure to purchase all of the lots by the June 30, 2004, deadline. Lakeside disputes the Debtor's ability to call the LOC for a variety of reasons.

This Adversary was commenced on September 4, 2003, with Plaintiffs' filing of their Complaint entitled Adversary Action to Obtain Declaratory Judgment, to Obtain Injunction or Other Equitable Relief, to Determine the Validity, Priority and Extent of a Lien or Other Interest in Property and to Recover Money [the "Complaint']. Following the filing by the various parties of numerous Answers, Counterclaims, Cross-Claims, Third-Party Complaints and other responsive pleadings, the parties agreed to try and settle their differences through the use of a mediator. After several months of trying, the parties were unable to reach accord and, on May 3, 2004, the Debtor requested that the Adversary be reactivated. The instant Motion for Permanent Injunction was filed by Lakeside on August 5, 2004. As a result of the Court's consideration of certain pre-trial motions, all of the Plaintiffs' causes of action lodged in their Complaint were dismissed. However, the Plaintiffs and the Debtor both assert that the issue of whether or not to grant a Permanent Injunction to enjoin the Debtor from drawing on the LOC is still alive, requiring a decision by the Court. The parties point to the Debtor's Answer to the Complaint, Counter Claims and Cross-Claims filed on September 22, 2003, and specifically to the Debtor's First Counterclaim (Declaratory Judgment of Executory Contract) as the jurisdictional predicate for the Court's

consideration of injunctive relief. Following the submission of briefs, the Court conducted a hearing on this matter on November 8, 2004.

The parties have presented the Court with several theories and arguments and cited many cases to support their respective positions. The Debtor's First Counterclaim frames the parties' dispute and provides the template for the Court's analysis in stating:

> The Real Estate Purchase and Sale Agreement is either not a contract, or is an executory contract subject to assumption or rejection in the administrative case. No such assumption or rejection has occurred.

The Debtor then requested that the Court declare that the Agreement either is not a contract, or is an executory contract subject to assumption or rejection only in the administrative case.

Prior to the Chapter 11 filing and particularly during the 14 month pendency of this litigation, the Debtor has argued these alternate, but inconsistent, positions. Specifically, at times when Lakeside sought to enforce the Agreement and require the Debtor to sell it lots, the Debtor asserted that no underlying contract ever existed. For example, the Debtor required new, separate contracts for lot sales made after the Agreement. Now apparently, the Debtor is content in asserting that a contract does exist, but it is an executory one, which has yet to be formally assumed or rejected. More importantly, the Debtor argues that the LOC is an independent contract that should be enforced and paid for the Debtor's benefit.

Lakeside argues that the case law and COLO. REV. STAT. § 4-5-109 (1996), formerly COLO. REV. STAT. § 4-5-114(2) (1985), entitle it to a Permanent Injunction preventing the Debtor from demanding, and the Bank from honoring, payment under the LOC. Lakeside asserts there is fraud in the transaction of such a material nature that this Court should enjoin payment.

For the reasons discussed below, the Court permanently enjoins the Debtor from making demand for payment of the LOC on the issuer of the LOC, Citywide Banks of Aurora, Colorado, or its customer Lakeside. As succinctly stated by the 9th Circuit Court of Appeals in the case of ***In re Mayan Networks Corp.***, "[l]etters of credit have yet to find a comfortable place in bankruptcy law." 306 B.R. 295, 301 (B.A.P. 9th Cir. 2004). After having considered this matter, this Court very much agrees with that sentiment.

DISCUSSION

Letter of Credit

Historically, the letter of credit arose to facilitate international commercial transactions for the sale and purchase of goods to ensure delivery to the buyer and prompt payment to the seller. In recent years, the use of the letter of credit has expanded to include guaranteeing or securing a bank's customer's promised performance to a third party in a variety of situations. This use is called a "standby letter of credit." *Colo. Nat'l Bank v. Board of County Comm'rs*, 634 P.d 32, 36, (Colo. 1981). The LOC is such an example.

Three relationships are created by a letter of credit transaction:

1. The underlying contract between customer and beneficiary, which in this case is the Agreement.

2. The contract between customer and its bank. Here, Lakeside pledged assets to secure the bank's obligation to pay if a demand were made on the LOC.

3. The relationship between bank and beneficiary of the letter of credit, here represented by the LOC itself.

Id.; *Dynamics Corp. of America v. Citizens Southern Nat'l Bank*, 356 F. Supp. 991, 995 (N.D. Ga. 1973)

Independence Principle

It is fundamental that a letter of credit is separate and independent from the underlying business transaction between the bank's customer and the beneficiary. Given this "independence principle," the bank, as issuer, is under a duty to honor the drafts for payment made by the beneficiary, which conform with the terms of the letter of credit, without reference to their compliance with the terms of the underlying contract. *Colo. Nat'l Bank,* 634 P.2d. at 36-37. "The arrangement is essentially an attempt to substitute the credit of the issuing bank for that of a customer. It is a form of guaranteeing payment." *W. Va. Housing Dev. Fund v. Sroka*, 415 F. Supp. 1107, 1112 (W.D. Pa. 1976). The bank's liability rests upon the letter of credit rather than the underlying performance contract between the bank's customer and the beneficiary of the letter of credit. As a result of the letter of credit's independence, generally neither it nor its proceeds are property of the estate. This is one reason why letter of credit issues fit so "uncomfortably" in a bankruptcy case. This case may provide another reason.

Where payment of a letter of credit is involved, courts have shown a general reluctance to enjoin the payments provided in that letter. *Ground Air Transfer v. Westates Airlines,* 899 F.2d. 1269, 1272-73 (1st Cir. 1990). A general proposition of contract law that courts have applied to letters of credit is "to take the words as strongly against the issuer as a reasonable reading will justify." *Sroka,* 415 F. Supp. at 1112 (quoting *Fair Pavilions, Inc. v. First Nat'l City Bank,* 264 N.Y.S.2d 255, 258 (N.Y. App. Div. 1965)). Secondly, "a construction of a letter of credit that will make the letter valid and enforceable will be preferred to one that will defeat it." *Sroka,* 415 F. Supp. at 1112 (citing *Dynamics Corp*., 356 F. Supp. at 999). This means that, generally, the issuer/bank cannot litigate the performance of the underlying contracts. The issuer of a letter of credit cannot look to the underlying transaction to supplement or interpret the terms of the letter of credit. *Ward Petroleum Corp. v. FDIC*, 903 F.2d 1297, 1300 (10th Cir. 1990). The issuer cannot look to a course of dealing or performance to justify dishonor of a facially conforming demand, since to do so would inject a complex litigable issue into every wrongful dishonor case. *Id.* at 1300. The issuing bank's function is simply to examine the documents presented to determine whether they are apparently regular and in compliance on their face with the terms of the letter of credit. *Fidelity Bank v. Lutheran Mutual Life Ins. Co.,* 465 F.2d. 211, 214 (10th Cir. 1972). "Generally, if the documents presented conform to the requirements of the credit, the issuer is not required or even permitted to go behind the documents before honoring demands for payment." *New York Life Ins. Co. v. Hartford Nat'l Bank & Trust Co.*, 378 A.2d 562, 567 (Conn. 1977). Here, however, Lakeside argues that the case law and Colorado's version of the Uniform Commercial Code [the "U.C.C."] prevent the Debtor from demanding payment under the LOC.

Fraud Exception

The independence principle is not without limitation. Justice Cardozo, dissenting in the early case of *Maurice O'Meara Co. v. Nat'l Park Bank of New York*, 146 N.E. 636 (N.Y.1925), foreshadowed the current fraud exception. In that case, the irrevocable letter of credit contained the specifications of the merchandise which was ordered. The bank refused to pay the drafts presented to it because it had no proof that the goods conformed to the specifications contained in the letter of credit. The court held that summary judgment should have been granted in favor of the seller because the issue of whether or not the goods conformed to the specifications was not relevant to the bank's duty to pay so long as the documents presented conformed to the letter of credit. Justice Cardozo wrote:

> I assume that no duty is owing from the bank to its depositor which requires it to investigate the quality of the merchandise. I dissent from the view that, if it chooses to investigate and discovers thereby that the merchandise tendered is not in truth the merchandise which the documents describe, it may be forced by the delinquent seller to make payment of the price irrespective of its knowledge. We are to bear in mind that this controversy is not one between the bank on the one side and on the other a holder of the drafts who has taken them without notice and

> for value. The controversy arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated payment may be resisted if the documents are false.
>
> I think we lose sight of the true nature of the transaction when we view the bank as acting upon the credit of its customer to the exclusion of all else. It acts not merely upon the credit of its customer, but upon the credit also of the merchandise which is to be tendered as security.

Id. at 641 (Cardozo, J., dissenting).

The U.C.C. reflects such an exception to a bank's obligations to honor an apparently conforming demand or draft when a required document is forged or fraudulent or there is fraud relating to the transaction itself. In the case of *Rockwell Intern. Systems, Inc. v. Citibank*, the court said

> The "fraud in the transaction" defense marks the limit of the generally accepted principle that a letter of credit is independent of whatever obligation it secures. No bright line separates the rule from the exception, to be sure, but . . . "fraud" embraces more than mere forgery of documents supporting a call.

719 F.2d 583, 588 (2nd Cir. 1983) (decided under U.C.C. § 5-114, the prior version of the current § 5-109).

Although a letter of credit is often loosely referred to as a contract between the issuer and beneficiary, "the relationship between issuer and the beneficiary is statutory, not contractual." *Ward Petroleum*, 903 F.2d at 1300 (quoting *Arbest Const. Co. v. First Nat'l Bank & Trust Co.*, 777 F.2d 581, 583 (10th Cir. 1985). Article 5 of the U.C.C., as adopted in Colorado, governs both traditional commercial letters of credit and standby letters of credit, and codifies the above general principles, including the fraud exception. Section 4-5-109, regarding Fraud and Forgery, states in relevant part:

> (a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:
>
> (1) The issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or

> nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and
>
> (2) The issuer, acting in good faith, may honor or dishonor the presentation in any other case.

COLO. REV. STAT. § 4-5-109(a).[1]

"Neither the Code nor its comments give any hint as to what type of fraud gives the bank an option to pay or not to pay under this section." *Mid-States Mortgage Corp. v. Nat'l Bank*, 259 N.W. 2d. 175, 177 (Mich. Ct. App. 1977) (quoting *Sroka*, 415 F. Supp. at 1114). "Fundamentally, 'fraud in the transaction,' . . . must stem from conduct by the beneficiary of the letter of credit as against the customer of the bank." *Colo. Nat'l Bank*, 634 P.2d. at 39. "It must be of such an egregious nature as to vitiate the entire underlying transaction so that the legitimate purposes of the independence of the bank's obligation would no longer be served." *Id*. (citing *Intraworld Indus.*, 336 A.2d 316, 324 (Pa. 1975); *New York Life*, 378 A.2d. at 567).

Certain courts have stated that this fraud exception "must be narrowly construed or it will swallow up the [independence] rule." *Ward Petroleum*, 903 F.2d at 1301 (citing *Roman Ceramics Corp. v. People's Nat'l Bank*, 714 F.2d 1207, 1212 (3rd Cir. 1983)). Those courts have generally thought the exception "to include an element of intentional misrepresentation in order to profit from another." *Colo. Nat'l Bank*, 634 P.2d. at 39 (quoting *Sroka*, 415 F. Supp. at 1114).

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[1] The earlier version of this statute provided:

> Unless otherwise agreed, when documents appear on their face to comply with the terms of a credit but a required document . . . is forged or fraudulent or there is fraud in the transaction:
> (a) The issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course . . . and in an appropriate case would make it a person to whom a document of title has been duly negotiated . . . or a bona fide purchaser of a certificated security . . . ; and
> (b) In all other cases, as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery, or other defect not apparent on the face of the documents; but a court of appropriate jurisdiction may enjoin such honor.

COLO. REV. STAT. § 4-5-114(2) (1985).

Some courts have given a broader interpretation to fraud under the U.C.C., or at least found they were faced with circumstances justifying the use of the fraud exception. Such courts have found that payment of a letter of credit may be enjoined, despite the independence principle, where fraud by the beneficiary is shown, thereby requiring the court to protect the bank's obligation from an "unscrupulous beneficiary." *See Sroka*, 415 F. Supp. at 1114 (citations omitted). Such courts view the fraud exception as flexible and find that "it may be invoked on behalf of a customer seeking to prevent a beneficiary from fraudulently utilizing a standby (guarantee) letter of credit." *Harris Corp. v. Nat'l Iranian Radio and Television*, 691 F.2d 1344, 1355 (11th Cir. 1982) (citations omitted).

Therefore, although the U.C.C. and the case law narrowly circumscribe the exceptions under which a court can enjoin an issuing bank from making payment on a letter of credit, they also illustrate that "[t]he law of 'fraud' is not static and the courts have, over the years, adapted it to the changing nature of commercial transactions in our society." *Dynamics Corp*, 356 F. Supp. at 998 (citing *S. E. C. v. Capital Gains Research Bureau*, 375 U.S. 180, 192-195, 84 S. Ct. 275, 283 (1963)). The *Capital Gains* case involved a security broker's tactics of recommending certain stock to customers, without disclosing his own holdings of the stocks and then selling his interests once the purchases by others raised the stocks' values. In *Capital Gains*, the Supreme Court noted that in a suit for equitable relief, it is not necessary that plaintiff establish all the elements of actionable fraud required in a suit for monetary damages, and it quoted with approval the following definitions of "fraud" in equity jurisprudence: "Fraud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element," 375 U.S. 180, 193-94, 84 S. Ct. 275, 284 (quoting De Funiak, HANDBOOK OF MODERN EQUITY (2nd ed. 1956), 235); and "Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." 375 U.S. 180, 193-94, 84 S. Ct. 275, 284 (quoting *Moore v. Crawford*, 130 U.S. 122, 128, 9 S. Ct. 447, 448 (1889).

The U.C.C. recodification, found in COLO. REV. STAT. § 4-5-109(a), makes it clear that fraud must be found either in the documents or must have been committed by the beneficiary on the issuer or applicant. The fraud must be material. "Necessarily courts must decide the breadth and width of 'materiality.'" U.C.C. § 5-114 cmt. 1.

Injunctive Relief

The current version of the U.C.C. specifically provides:

> If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or

> permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:
>
> (1) The relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
>
> (2) A beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
>
> (3) All of the conditions to entitle a person to the relief under the law of this State have been met; and
>
> (4) On the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1) of this section.

COLO. REV. STAT. § 4-5-109(b). Thus, a court may enjoin payment of a letter of credit where either the documents presented to the issuing bank are forged or fraudulent or there is "material fraud" related to the transaction. "This section provides an important exception to the general rule that the parties' respective rights and liabilities on a letter of credit are independent of the underlying transaction." *Itek Corp. v. First Nat'l Bank,* 511 F. Supp. 1341, 1350 (D. Mass. 1981) (citations omitted) (case decided prior to the recodification).

> The *Itek* court said
>
> The need for this exception becomes apparent when one considers the function letters of credit are designed to perform in facilitating commercial transactions. Briefly, letters of credit, including "standby" letters intended to guarantee performance . . . are designed to insure that neither party to a contract enjoys the benefits of both his own and the other party's performance at the same time. In other words, letters of credit eliminate the need for one party to extend credit to the other. Where, however, a party by means of fraudulent conduct seeks to obtain the benefits of both performance and payment, the fundamental purpose underlying the letter of credit could be undermined unless injunctive relief were available

Itek, 511 F. Supp. at 1350) (citing Note, *"Fraud in the Transaction": Enjoining Letters of Credit During the Iranian Revolution,* 93 HARV. L. REV., 992, 1000, 1009 (1980) [hereinafter *Enjoining Letters of Credit*].

As previously discussed, the older case law and the U.C.C., prior to its recodification, first formulated the classic, narrow view of the fraud exception based on the beneficiary's egregious performance. This is where "the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served." *Intraworld*, 336 A.2d at 324-25; *see also Colo. Nat'l Bank*, 634 P.2d. at 39; *New York Life*, 378 A.2d.at 501; *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631, 634 (N.Y. Sup. Ct. 1941). "[T]he legislative history of section 5-114(2) indicates that 'fraud in the transaction' was meant to embody an exception to the independence principle and provide for injunctive relief based solely on the beneficiary's misperformance of the underlying contract." *Enjoining Letters of Credit, supra* at 1004.

Such situations may exist where 1) a beneficiary so egregiously misperforms his duties under the underlying contract as to essentially destroy it; or 2) where a party attempts to gain the benefit of a credit or a contract without discharging his own obligations in the transaction. Although the beneficiary may fail to perform or may render performance of the underlying contract impossible, it may still attempt to demand payment on the credit because the letter of credit documents appear on their face to comply and be proper. *See generally Enjoining Letters of Credit, supra* at 1001-7.

In such situations, courts have found that "the principle of independence of the bank's obligation under a letter of credit should not be extended to protect an unscrupulous seller," i.e. beneficiary. *Sztejn*, 31 N.Y.S.2d at 635-36 (develops concept of unscrupulous seller and refuses to dismiss complaint alleging that facially compliant documents requesting payment are fraudulent since they do not represent actual merchandise, but instead cover boxes fraudulently filled with worthless material); *Merchants Corp. v. Chase Manhattan Bank*, 5 UCC Rep. Serv. 196 (N.Y. Sup. Ct. 1968) (injunction against honor entered where bank notified of forged documents, even though correct in form to comply with letter of credit); *Roman Ceramics Corp. v. Peoples Nat'l Bank*, 517 F. Supp. 526, 537 (M.D. Pa. 1981) (finding beneficiary trying to get paid twice on same invoices to be unscrupulous); *Larson v. First Interstate Bank*, 603 F. Supp. 467 (D. Ariz. 1983) (preliminary injunction issued for questions of whether beneficiary's breach of underlying contract may have caused customer's default triggering beneficiary's demand for payment under letter of credit, and whether such demand is therefore fraudulent); *see also Stromberg-Carlson Corp. v. Bank Melli Iran*, 467 F. Supp. 530 (S.D.N.Y. 1979); *Pine Tree Electric Co. v. E.A. Gralia Construction Co.*, 16 B.R. 105 (Bankr. D. Me. 1981).

The recodification, reflected in the current COLO. REV. STAT. § 4-5-109, "indorses articulations [of the fraud exception] such as those stated in [*Intraworld*, 336 A.2d at 324, *Roman Ceramics*, 714 F.2d at 1212], and similar decisions and embraces certain decisions under Section 5-114 that relied upon the phrase 'fraud in the transaction.'" U.C.C. § 5-109 cmt. 1. Post-recodification cases addressing the fraud exception often cite the prior formulations when considering the issue of "material fraud." Such fraud by the beneficiary "occurs when the

beneficiary has *no colorable right* to expect honor or where there is no basis in fact to support such a right of honor." U.C.C. § 5-109 cmt. 1; *see also Ground Air Transfer, Inc. v. Westates Airlines, Inc.*, 899 F.2d 1269, 1272-73 (1st Cir. 1990); *Ward Petroleum*, 903 F.2d at 1301; *Itek Corp. v. First Nat'l Bank*, 730 F.2d 19, 25 (1st Cir. 1984); *Roman Ceramics*, 714 F.2d at 1214; *Dynamics Corp.*, 356 F. Supp. at 999; *Intraworld*, 336 A.2d 316. Thus, although the wording of the fraud exception differs between the original version ("fraud in the transaction") and the current version ("material fraud"), both formulations refer to the same behavior. Material fraud does not need to occur at the inception of the agreement, but the lack of any performance by the beneficiary may make the demand for payment fraudulent in and of itself.

Executory Contract

"Section 365 of the Bankruptcy Code provides in pertinent part that the trustee, subject to court approval, may assume or reject any executory contract or unexpired lease of the debtor." *Leslie Fey Companies v. Corporate Property Assoc.* 3, 166 B.R. 802, 808 (Bankr. S.D. N.Y. 1994). Generally, a contract is considered to be executory if some performance remains due on both sides of the agreement. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n. 6, 104 S. Ct. 1188, 1194 n. 6 (1984). Assumption of an executory contract under § 365 has the effect of preventing the other contracting party from terminating the contract. *In re Ionosphere,* 85 F.3d 992, 998-99 (2nd Cir. 1996). However, if an executory contract is assumed, it is said to be assumed *cum onere,* with all of its benefits and burdens. *Bildisco,* 465 U.S. at 531-32, 104 S. Ct. at 1199. "An executory contract cannot be assumed in part and rejected in part." *In re Cajun Elec. Power Co-op., Inc*. 230 B.R. 693, 710 (Bankr. M.D. La. 1999) ("The trustee must either assume the entire contract, cum onere, or reject the entire contract, shedding obligations as well as benefits."); *Leslie Fay Co. v. Corporate Property Assoc. 3 (In re Leslie Fay Co.)*, 166 B.R. 802, 808 (Bankr. S.D. N.Y. 1994).

The court in *Public Service Co v. New Hampshire Electric Coop. (In re Public Service Co.)*, described the process as follows:

> The Bankruptcy Code prescribes a set course of treatment for executory contracts. Acting in the debtor's interest, the trustee, "subject to the court's approval, may assume or reject any executory contract . . . of the debtor." Ordinarily, the debtor need not commit itself to assumption or rejection of such a contract until a reorganization plan is confirmed. In the meantime, the executory contract remains in effect and creditors are bound to honor it. If and when assumed, the contract operates according to its tenor. On the other hand, eventual rejection "constitutes a breach of such contract;" and the breach, in accord with what has been termed the "relation-back" doctrine, is treated as if it had occurred prepetition, that is, before the bankruptcy proceeding began. Parties who wish to know where they stand may, pursuant to 11 U.S.C. § 365(d)(2), seek to compel an

> early election: "the court, on the request of any party to [an executory] contract . . . may order the trustee to determine within a specified period of time whether to assume or reject such contract . . .." But there is no assurance that the judge will acquiesce. The interests of the creditors collectively and the bankrupt estate as a whole will not yield easily to the convenience or advantage of one creditor out of many.

884 F.2d 11, 14-15 (1st Cir. 1989) (quoting 11 U.S.C. § 365) (citing Bordewieck, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM.BANKR.L.J. 197, 200, 211-13 (1985); 11 U.S.C. 502(g)).

"If the debtor is in default on the contract, it will not be allowed to assume the contract unless, at the time of the assumption it, *inter alia*, (a) cures, or provides adequate assurance that it will promptly cure, the default, and (b) provides adequate assurance of its future performance of its obligations under the contract." *Eastern Airlines, Inc. v. Ins. Co. of Penn. (In re Ionoshere Clubs, Inc.)*, 85 F.3d 992, 999 (2nd Cir. 1996). "Congress's intent in imposing these conditions on the ability of the debtor to assume the contract was "to insure that the contracting parties receive the full benefit of their bargain if they are forced to continue performance." *Id*. (quoting *In re Superior Toy & Manufacturing Co.*, 78 F.3d 1169, 1174 (7th Cir.1996)).

"The Code is silent on the rights and obligations of the parties to an executory contract . . . during the limbo period – that is, the period between the filing of the petition and the time of assumption or rejection." *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (quoting G. TREISTER, J.R. TROST, L. FORMAN, K. KLEE & R. LEVIN, FUNDAMENTALS OF BANKRUPTCY LAW § 5.04(e), at 247 (5th ed.2004))). However, certain cases do provide the Court with some insight to resolving the issues before it. A debtor's attempts to enforce contract do come with a cost.

As stated above, "[d]uring the pre-assumption period, although non-debtors are required to perform in accordance with a contract . . . , the contract's terms are 'temporarily unenforceable against the debtor' . . .." *In re Travelot Co.*, 286 B.R. 462, 466 (Bankr. S.D. Ga. 2002) (quoting *Univ. Med. Ctr. v. Sullivan (In re Univ. Med. Ctr.)*, 973 F.2d 1065, 1075 (3rd Cir. 1992) (internal citations omitted)). In this "limbo" state, an executory contract under Chapter 11 is not enforceable against the debtor party, but is enforceable against the non-debtor party prior to the debtor's assumption or rejection of the contract. *Skeen v. Denver Coca-Cola Bottling Co.* (*In re Feyline Presents, Inc.*), 81 B.R. 623, 626 (Bankr. D. Colo. 1988) (citing *Bildisco*, 465 U.S. at 532, 104 S. Ct. at 1199). "In that interim period . . . the parties to the contract may continue to perform their respective roles." *Id.*

However, "[a] debtor-in-possession which 'elects to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract' must, nevertheless,

pay for the reasonable value of those services." *Travelot*, 286 B.R. at 466 (quoting *Bildisco* 465 U.S. at 531, 104 S. Ct. 1188). That value, "depending on the circumstances of a particular contract, may be what is specified in the contract." *Bildisco*, 465 U.S. at 531, 104 S. Ct. at 1199; *see also Goldin v. Putnam Lovell, Inc.* (*In re Monarch Capital Corp*.), 163 B.R. 899, 907-908 (Bankr. D. Mass. 1994) (non-debtor party to pre-petition contract was entitled to reasonable value of services actually conferred on debtor during post-petition, pre-assumption/rejection period). Likewise, in the case of *In re StarNet, Inc.*, 355 F.3d 634 (7th Cir. 2004), the 7th Circuit recently stated

> that neither § 365(a) nor anything else in bankruptcy law entitles debtors to more or different services, at lower prices, than their contracts provide. Section 365(a) gives debtors a right to walk away before the contract's end (with the creditor's entitlement converted to a claim for damages), not a right to obtain extra benefits without paying for them. In the main, and here, bankruptcy law follows non-bankruptcy entitlements.

Id. at 637 (citing *Bildisco*, 465 U.S. 513, 104 S. Ct. 1188; *Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 20, 120 S. Ct. 1951 (2000); *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914 (1979)). The 10th Circuit has expressed similar views in *Country World Casinos, Inc. v. Tommyknocker Casino Corp. (In re Country World Casinos, Inc.)*, 181 F.3d 1146 (10th Cir. 1999), in upholding "the principle that 'a party to a contract cannot claim its benefits where he is the first to violate its terms.'" *Id*. at 1150 (quoting *Western Plains Serv. Corp. v. Ponderosa Dev. Corp.*, 769 F.2d 654, 657 (10th Cir. 1985)).

The above opinions are consistent with Colorado law as indicated by the case of *Daybreak Const. Specialties v. Saghatoleslami*, 712 P.2d 1028 (Colo. Ct. App. 1985).

> It is undisputed that the contract was bilateral and contained mutual promises. Each party was under a legal duty to the other; each had made a promise and each was an obligor. When the obligations of a contract for sale and purchase of land are mutual and concurrent, so long as one party makes no tender of deed and the other no offer of payment, neither is in default.
>
> A party's duty to pay damages for non-performance of a contract is discharged if it appears after the breach that there would have been a total failure by the injured party to perform his return promise. Thus, where both parties to a contract are in default, there can be no recovery by either against the other. Accordingly, the contract purchasers may not recover for an alleged breach of contract unless they can establish by a preponderance of the evidence that, except for its breach, the developer would have received "substantially what it bargained for."

Id. at 1031-32 (citing *Howlett v. Greenberg*, 530 P.2d 1285 (Colo. Ct. App. 1974); *Kepler v. Burns*, 324 P.2d 785 (Colo. 1958); RESTATEMENT (SECOND) OF CONTRACTS § 244 (1981); *Rubinger v. Rippey*, 110 N.Y.S.2d 5 (N.Y. App. Div. 1951); *Yale Development Co. v. Aurora Pizza Hut, Inc.*, 420 N.E.2d 823 (Ill. Ct. App. 1981); *Hodes v. Hoffman Int'l Corp.*, 280 F. Supp. 252 (S.D.N.Y.1968)).

Permanent Injunction Standards

The Court must now address whether or not the Debtor should be permanently enjoined from demanding payment under the letter of credit.

The Debtor's pleadings and the evidence at hearing demonstrate to the Court's satisfaction that Mr. Yaklich, the Debtor's principal, does not really believe that a binding contract between the parties actually exists. In his sworn deposition testimony dated October 18, 2002, he expressed the view that the Agreement was, at best, a letter of intent to purchase lots. He believed that it was nothing more than an agreement to try and work out an agreement, which the parties never did do, ever. Likewise, at hearing here, Mr. Yaklich questioned the validity of the Agreement with Lakeside, since he did not approve certain performance deadlines inserted into the Agreement by Lakeside after he signed it on the Debtor's behalf. Finally, the Debtor demonstrated this position during the course of business between the parties by requiring that the parties enter into new contracts for the sale of certain lots. The Debtor, with Court permission, did sell an additional six lots to Lakeside, but pursuant to separate, new sale contracts, not the pending Agreement. However, Lakeside's requests to buy additional lots from the Debtor went unfulfilled, because the Debtor desired to obtain a global settlement of all pending litigation and disputes before agreeing to part with any more lots. Therefore, based on Mr. Yaklich's testimony, and the Debtor's actions, the Court cannot reasonably find that the Debtor can enforce the Agreement so as to demand payment of the LOC provided for therein.

Even assuming that the Agreement does represent a valid contract between the parties, the Court cannot conclude, under the circumstances of this case, that the Debtor should be allowed to make demand under the LOC. This conclusion is based upon the Court's prior analysis of the law concerning letters of credit and executory contracts.

In deciding whether or not to permanently enjoin the Debtor from calling the LOC, the Court must consider the facts of the case in light of the elements set forth in COLO. REV. STAT. § 4-5-109(b). Under that statute the Court may enjoin the Debtor from attempting, and the Bank from honoring, presentment of the LOC, where Lakeside "claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant" and where the court finds:

> (1) The relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
> (2) A beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
> (3) All of the conditions to entitle a person to the relief under the law of this State have been met; and
> (4) On the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1) of this section.

COLO. REV. STAT. § 4-5-109(b).

No allegations of forged or fraudulent documents have been made here. Lakeside argues instead that the Debtor's attempt to enforce its demand for payment under the LOC constitutes "fraud in the transaction; a fraud upon the Court." Lakeside has, therefore, invoked COLO. REV. STAT. § 4-5-109 by making the claim that honor of the LOC would facilitate a material fraud. The Court will address the four elements it is required to find in order.

> *(1) The relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;*

Acceptance of a letter of credit and the incurring of a deferred obligation by the issuer are interim steps to the actual honor of a letter of credit in some cases where the letter of credit contains such provisions. *See* COLO. REV. STAT. § 4-5-102. The Court's review of the LOC reveals no such provisions. Even if they were present in the LOC, the posture of this case is such that "the law applicable to an accepted draft or deferred obligation incurred by the issuer" would not prohibit an injunction in this case. This is not a case where the issuing Bank seeks to enjoin honor of the LOC after acceptance or after incurring a deferred obligation. Presentment has taken place, but the Bank has neither formally accepted the LOC or incurred a deferred obligation. This Motion was filed by Lakeside shortly after presentment and before the Bank took any action. Therefore, the requested relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer.

> *(2) A beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;*

From the facts of this case, the Court finds that any failure of Lakeside to purchase lots from Tabernash is not the result of Lakeside's inability or unwillingness to make the purchases. Instead, it is the direct result of Tabernash's refusal to recognize the Agreement and, later, its inability to convey lots due to the District's foreclosure action. Thus, Tabernash, the beneficiary,

will not be adversely affected by the relief granted in this action. To the contrary, if the Court should fail to grant the relief, Tabernash would enjoy a windfall.

(3) All of the conditions to entitle a person to the relief under the law of this State have been met;

In the state of Colorado "[g]enerally, a party seeking a permanent injunction must show that [a] the party has achieved actual success on the merits; [b] irreparable harm will result unless the injunction is issued; [c] the threatened injury outweighs the harm that the injunction may cause to the opposing party; and [d] the injunction, if issued, will not adversely affect the public interest." *Employment Television Enterprises, LLC v. Barocas* 100 P.3d 37, 44 (Colo. Ct. App. 2004); *see also Fisher v. Oklahoma Health Care Authority*, 335 F.3d 1175, 1180 (10th Cir. 2003) ("A party requesting a permanent injunction bears the burden of showing: (1) actual success on the merits; (2) irreparable harm unless the injunction is issued; (3) the threatened injury outweighs the harm that the injunction may cause the opposing party; and (4) the injunction, if issued, will not adversely affect the public interest.") (citing *Fed. Lands Legal Consortium ex rel. Robart Estate v. United States*, 195 F.3d 1190, 1194 (10th Cir.1999); *Amoco Prod. Co. v. Gambell*, 480 U.S. 531, 546 n. 12, 107 S. Ct. 1396 (1987)).

(a) Lakeside has achieved success on the merits. As noted above, the evidence in this case has satisfied the Court that Tabernash has no colorable claim to collect liquidated damages under the Agreement. Lakeside's failure to purchase lots is due to the actions of Tabernash.

Tabernash has not sought to formally assume the Agreement in accordance with 11 U.S.C. § 365. To the contrary, the Debtor's proposed Chapter 11 Plan, pending in the main case, states that the Agreement will be rejected. Therefore, the Agreement is in a state of "limbo," having not been assumed nor rejected. Yet, in this adversary action, the Debtor seeks to have the Court award it the benefits of the Agreement – $250,000 under the LOC – without having to endure the detriments of that Agreement – selling any additional lots to Lakeside – and without having assumed the Agreement.[2] Ironically, as indicated previously, the Debtor seeks to enforce the Agreement about which its principal has previously testified that he believed did not exist.

Either of the Debtor's positions here, that the Agreement does not exist or it is a yet to become a rejected executory contract, demonstrate that the Debtor is trying to get the extra benefit of the LOC without having rendered performance under the Agreement.

[2] Inexplicably, Lakeside failed to exercise its remedies under § 365(b) and file a motion to require the Debtor to assume or reject the Agreement prior to plan confirmation. As a consequence, this issue, which might have been addressed early in the case, becomes the final matter to be decided in an otherwise dismissed case.

Tabernash cites the Court to a series of cases in support of the proposition that, during the pendency of a chapter 11 case and before plan confirmation, an executory contract is enforceable against the non-debtor party but not against the debtor. *N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 532, 104 S. Ct. 1188, 1199 (1984); *Data-Link Systems, Inc. v. Whitcomb & Keller Mort. Co. (In re Whitcomb & Keller Mort. Co.)*, 715 F.2d 375, 378 (7th Cir. 1983); *Hall v. Perry (In re Cochise College Park, Inc.)*, 703 F.2d 1339, 1354 (9th Cir. 1983); *Skeen v. Denver Coca-Cola Bottling Co. (In re Feyline Presents, Inc.)*, 81 B.R. 623 (Bankr. D. Colo. 1988). While true, as far as that statement goes, that does not imply that a debtor is free to demand payment from the non-debtor party while unable, or refusing, to perform its own obligations. In none of Tabernash's cited cases was a debtor allowed to demand performance from the non-debtor party during the post-petition and pre-confirmation period and yet utterly avoid any reciprocal obligation. *Bildisco*, 465 U.S. at 531, 104 S. Ct. at 1199 ("If the debtor-in-possession elects to continue to receive benefits from the other party to an executory contract pending a decision to reject or assume the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services."); *Data-Link*, 715 F.2d at 379 ("Here it is undisputed that [the Debtor] paid in full for all services rendered during the administration of the estate . . .."); *Cochise College Park*, 703 F.2d at 1354 ("[P]ayments received by the trustee on an executory contract during the period between the date of filing and the date of rejection do become property of the estate. However, these payments give rise to claims against the estate of an administrative expense priority in the amount of the reasonable value of the consideration tendered to the trustee."). In *Feyline*, the non-debtor party to an executory contract unilaterally breached the contract post-petition and that breach gave rise to the debtor's action for damages. 81 B.R. at 627. In this case, the evidence persuades the Court that Lakeside stood ready to purchase lots and that it was the Debtor who refused to recognize that a contract even existed. Thus, the cases cited by Tabernash have failed to persuade the Court that the Debtor would not be committing a material fraud against Lakeside if it is allowed to collect liquidated damages under an Agreement, the existence of which it has refused to acknowledge.

In the first instance, the Debtor asserts that it did not breach the Agreement. It argues that there never was a binding contract since it did not approve certain performance deadlines inserted into the Agreement by Lakeside after the Debtor signed it. Now, since Lakeside did not ultimately buy all of the lots by June 30, 2004, the Debtor seeks to recover on the LOC set up by that Agreement. The Code, under § 365, spells out the conditions for a debtor to gain the enjoyment of an executory contract through assumption. But this Debtor wants the benefits of the Agreement, without the detriments that assumption would entail, such as cure of defaults, assurance of future performance, and transfer of the lots. The Court finds such conduct to be the kind of unscrupulous behavior sought to be remedied by the fraud exception.

(b) Lakeside will suffer irreparable harm if its application for permanent injunction is not granted. The concept of irreparable harm generally denotes the absence of an adequate remedy at law. Typically, where the transgression may be remedied by an award of money damages, irreparable harm will not be shown. If the Court does not grant the permanent injunction in this

case, theoretically, Lakewood would have a remedy at law by bringing a suit for money damages against Tabernash. But, the Court has two concerns that lead it to conclude that Lakewood would suffer irreparable harm if Tabernash is allowed to draw on the LOC. The first is the futility of litigating this matter all over again in another forum when Lakewood has already demonstrated that Tabernash is not entitled to liquidated damages under the Agreement. Lakewood has proven that Tabernash has no colorable right to damages, and that allowing it to draw on the LOC would constitute a material fraud. For the Court to deny the injunction would facilitate Tabernash's fraud. Lakewood should not be put to the burden of relitigating identical issues in another action to remedy the fraud which should have been prevented in this proceeding. Secondly, in reality, Lakewood does not have an adequate remedy at law. Its ability to collect a money judgment against, Tabernash, a bankrupt LLC, is speculative at best.

(c) The threatened injury to Lakeside outweighs the harm that the injunction may cause to Tabernash. By denying Tabernash the right to commit a material fraud and to collect money to which it has no colorable right, Tabernash suffers no legally cognizable harm. By contrast, allowing Tabernash to draw on Lakeside's $250,000.00 LOC represents a palpable and substantial harm. Lakeside has received nothing in return for its $250,000.00 and Tabernash has made little or no effort whatever to perform its obligations under the Agreement.

(d) The injunction, if issued, will not adversely affect the public interest. By refusing to enjoin Tabernash from drawing on the LOC, the Court would, in essence, be facilitating a fraud. Certainly, there is no harm to the public interest if the Court does enjoin such behavior.

> *(4) On the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1) of this section.*

The first part of this element is satisfied because, as previously discussed, Lakeside has already satisfied the Court that allowing Tabernash to draw on the LOC would constitute a material fraud. The second part is satisfied because Tabernash does not qualify for protection under COLO. REV. STAT. § 4-5-109(a)(1). The parties entitled to such protection are parties that have given value for obligations in connection with a letter of credit and are without notice of defects. Tabernash does not fall within one of the enumerated categories of claimants.

For the above stated reasons, it is

ORDERED that Tabernash Meadows, LLC is PERMANENTLY ENJOINED from demanding payment under the Irrevocable Standby Letter of Credit dated August 7, 2000.

Dated this 15th day of February, 2005.

BY THE COURT:

/s/ Howard Tallman
Howard R. Tallman, Judge
United States Bankruptcy Court